July 19, 2011

To: New Mexico Legislators

From: AFSCME

Re: **Pension Solvency and Reform Ideas**

The following ideas represent suggestions from AFSCME, and AFSCME alone. We do not and cannot speak for any other union, although we have had some very positive discussions with CWA, police, fire, and other unions.

We hope that the fact that AFSCME has brought significant cost-saving and good-policy ideas to the table will not be used against AFSCME if others oppose these changes. In particular, it would be the height of irony and incredibly punitive if, say, corrections officers represented by AFSCME were held to lower pension benefits in the future but other public safety unions' members had a higher benefit simply because they did not come to the table with suggestions to save the fund.

This memo is divided into three major sections: major changes, which should generate significant savings to PERA funds; smaller changes, which may primarily be helpful for policy reasons but which also may have a beneficial impact to PERA funds; and defensive positions, which are essentially preservations of the status quo. None of the ideas here—none—worsen the financial situation for PERA, and almost all of them help it at least marginally.

We hope that a core group of legislators from both parties, in both chambers, will take these ideas and ask for an actuarial study of them. Pension reform is complex and has many interested parties, so lining up broad support for a specific plan well ahead of the next session will prevent the kind of meltdown that invariably happens when legislation as complex as this is amended on the fly during the session.

Section 1: Major savings to PERA fund liability

Most of the experts who have testified over the last few years at our interim committee hearings have consistently said that there are three major ways to reduce liabilities: require and/or incent people to work longer, reduce and/or delay COLAs, and lower the multiplier (the number which, multiplied by final average salary and years of service equals the final pension benefit). We would include a fourth concept in this "major savings" category: expanding the number of years used to calculate final average salary from 3 to 8.

A. Change the retirement age. Many states use a "Rule of ##" policy, where a member can retire with a certain combination of age and years of service.

One of the real problems, especially from a public perception point of view, is that people can graduate from high school, work 25 years at a safe desk job, and retire at 43 years old with 75% of their 3 year high FAS. That's simply not a retirement plan, and the public isn't entirely wrong in resenting it. Even if the vast majority of pension funding comes from employees and investment returns, rather than directly from the taxpayer, there's just a sense that it's wrong. I would propose a "Rule of 85" for non-public safety workers. (The combination of age and years of service would have to equal 85).

That means someone starting right out of high school would have to work 33.5 years to retire, or 8.5 more years than they currently have to, and only a handful would ever be able to retire before 55.

Someone starting at 35, which is the average starting age for state employees, would have to work until they were 60 to meet the Rule of 85.

Reform legislation could mandate that a minimum number of years be required in addition to the Rule of 85 (in Rep. Heaton's legislation, which controls non-public safety eligibility today, there is a Rule of 80 which actually allows many workers who start later in their careers to retire before age 65 with less than 25 years of service).

In order to keep public safety at an earlier retirement, we could simply "enhance" their years of service credit to reflect something similar to their current advantage over non-public safety workers. It will be slightly more complicated than under the current system where many public safety workers (like state police and state adult corrections officers) simply receive an extra 20% for each year served, because years of service is only half of the Rule of 85 calculation.

We have prepared spreadsheets on what some enhancements might look like and are happy to share them with legislators¸ but the short version is that public safety workers who start in their late teens would have to work closer to 25 or 26 years, while those who start closer to 25 years old would have to work in the 22-24 year range. Those with a later start in public safety would have to work less, but the reform could always establish a minimum number of years of service credit in addition to the Rule of 85.

Regardless of the final details of a Rule of 85 structure, employees would be allowed to start collecting their pensions upon reaching age 65 with whatever number of years are required to vest (currently 5 years, proposed to go to 8).

Estimated savings: will require actuarial analysis, but for non-public safety, the minimum number of years required before retirement will be 8.5 years longer than under the 25 and out system for people who start right out of high school, and 3.5 years longer for those same people than under Rep. Heaton's plan which went into effect last year. We have prepared a spreadsheet showing the amount of years required to serve prior to being eligible for retirement under the 25 and out system, under the current system, and under a proposed Rule of 85.

B. Reconfigure the COLA. As with other ideas here, this should only be applied prospectively. Both legally and as a matter of basic fairness, there's no way employers should bait-and-switch people they've already hired, and certainly no way those who are already vested should have their pension deal broken.

A first idea is to tie COLA to CPI, with a cap and floor so that neither the retiree nor the state gets hit too badly by extremes. Social Security does this, and even though there are some good arguments that seniors, with heavier health costs, may deserve an even higher COLA than CPI, those arguments are countered by the fact that Medicare is still such a strong program, at least for those over 65.

A second idea is to delay COLA for an additional two years. One benefit of delaying a COLA is that it may help incent workers to stay at their job to increase their Final Average Salary. If you know you can get a 3% increase in a year or two, it makes no sense to keep working to marginally increase your base salary. A suggestion we received from a House Appropriations Republican is to tier the delay in COLA, so that it kicks in four years after an employee retirees if they retire before 60, but only two years after retirement if the employee retires after 60.

Estimated savings from moving to CPI: 0%-3% *each year* depending on actual CPI, compounded.

Estimated savings from delaying COLA for four years total: since current delay is two years, the additional two years would save 6.1% from the status quo (although this would not apply to anyone retiring after 60 if you adopted the HAFC Republican's tiering concept).

C. Lower the multiplier. The current formula to figure out the pension in most plans is to take the Final Average Salary (discussed below), multiply by years of credited service (expressed in hundredths, so 25 years = 0.25), and then multiply by a "multiplier", which for many plans is 3. In other words, under the current multiplier, if someone retires after 25 years they get 75% of their Final Average Salary.

Someone retiring after 25 years would get 60% of FAS, while someone working for 30 years would get 75% of FAS, and the cap could be raised to 90% of FAS for someone making it to 35 years. That would be an actual improvement over the 80% cap we currently have, but it would incent people to work longer--through their most productive years.

One of the best ways for the fund to become more solvent is to have people work longer, so that they're not drawing down on the fund for as many years. This would achieve that goal in a positive, incentive-laden way. It has an additional solvency benefit in that those who work fewer years wouldn't create as much of a liability as they do if the multiplier is constant throughout a career.

Estimated savings: 16.67% from status quo for non-public safety; public safety savings would depend on how much of an enhancement the reform legislation maintained for public safety.

D. Base final average salary calculations off of the employees' highest 8 years (match the vesting period) instead of 3 for PERA. This is a controversial idea, because it really does lower the pension received by future employees, and that's a tough thing for a union guy to argue. But here are four reasons why it makes sense:

1) If we're trying to improve pension solvency in all of the funds, this is a way to do it that spreads out a relatively small hit on every single future employee without dramatically changing their pension.

For example, let's say that a worker's last 8 years under the current 25 year retirement in State General Plan 3 consists of 2.5% raises starting at $20,000 (the percentages work for any starting salary). The last salary would be $23,774 with a 3 year FAS of $23,199 and an 8 year FAS of $21,840.

Assume the employee retires with a 2.5% multiplier (multipliers are discussed above—this is merely coincidence that it is the same number as a hypothetical raise in this example) after 30 years. He or she would receive 75% (30 years times a 2.5% multiplier) of Final Average Salary. The final pension would be $17,399 using a 3 year FAS and $16,380 using an 8 year FAS. Not that an extra $19.60 a week wouldn't be great, but the pension isn't that far off—it would be 5.8% lower--and still a solid pension for the wages earned.

If all future employees took that hit, it would do a lot for the fund's solvency, but the pain would be spread very evenly. The percentages are identical if that employee had started at $40,000, or $60,000—a 5.8% reduction in the pension. If raises average more than those in this example, the savings to the fund are even greater: Using 5% salary increases, for example (which has never happened for 8 straight years), this change would save the fund over 10% of pension liability.

Lower raises at the end of a career than the hypothetical 2.5% used here would save less than the 5.8%.

The second way increasing FAS years makes sense is that it's the easiest, cleanest, simplest, fairest way to mitigate "spiking". Spiking occurs in several forms, but perhaps the most common and, to the public, most egregious, is when someone chugs along at that $25,000 a year job, maybe gets up to $35,000, and then in their last three years gets a big promotion--maybe to a deputy secretary position in the state, and starts pulling in $80,000. Suddenly that $18,000 or $20,000 pension can jump to $60,000 a year. That's terrible for several reasons: first, it's bad for the funds. The worker and employer didn't put in nearly enough money to support that large a pension, even assuming 8% annual market gains by the fund. If the person lives an additional 25 years after retiring, spiking is costing their fund somewhere around an additional $1 million. While spiking isn't always this dramatic, and doesn't happen too often, it happens enough that moving away from a 3 year FAS makes sense.

A third argument for expanding the final average salary length is that if newly-promoted people want to get a better pension, they have to stay in the new position longer. Since many people don't get their big promotion until they have over 20 years into the system, if you want to have an incentive to keep them around in their prime years, make sure they don't max out their pension in just three years--give them a financial reason to stay by not letting their new salary be their entire FAS until 8 years.

The fourth reason for increasing the years in the FAS calculation is that spiking is a public relations nightmare. A few Larry Barker stories later, and the public thinks that all public employees are gaming the system. Look, no one blames anyone for taking advantage of spiking, but why on earth would we keep it in place for people to take advantage of? When the public thinks public employee pensions are a sham, it isn't long until the savvy politicians play on that resentment, even if it’s based on a relatively small number of workers.

Estimated savings: 5.8% savings from status quo assuming a 2.5% average raise during the last 8 years of a career. Savings will be higher if average raises are higher than 2.5%, and savings will be lower if raises are lower.

Section 2: Policy changes and smaller savings ideas

A. Expand the vesting period from 5 to 8 years. Right now, PERA and ERA have vesting periods of five years. Moving it to eight years accomplishes several important objectives: 1) it helps the funds' solvency. When people leave before vesting, they get the share of money back that they put in (with a healthy 5.25% compounded interest in PERA's case, by the way, which we'll get back to). That's a loss to the fund. But the employer share of contributions stays with the fund forever, and once the worker's money is out, there is no longer any long-term liability. That's great for the fund. 2) It doesn't really hurt anyone. When people don't vest, they still get a nice lump-sum payment. Many people who are young and only put in 5, 6, or 7 years would actually prefer a one-time check of $25,000 or so to a small pension that they wouldn't get until they turn 65 (which would be eroded by inflation during the intervening 30 or 35 years--no one gets a COLA until after they start drawing their pension). 3) Longer vesting periods may incent some good workers to stay longer. The state, like any other employer, trains its workers, and as in almost any job not requiring physical strength, stamina, or agility, people get better as they get older and more experienced. While that's not necessarily a boon to PERA, it's a good policy argument for longer vesting periods.

B. Lower or eliminate that guaranteed rate of return on non-vesting employees' contributions. There's no constitutional requirement, to our knowledge, that PERA pay a guaranteed 5.25% rate of return on non-vesting employees' contributions. When we are seriously considering reducing COLAs for retirees (current or future), why are we paying 3 times the inflation rate to people who aren't even sticking around for more than a few years? It may only be a few million dollars a year, but this is some of the lowest-hanging fruit you can imagine. And it can be argued that if PERA doesn't legally have to pay out the interest on the employee share, it is obligated to the fund to not pay out bonus interest voluntarily as a "nice" gesture.

C. Toughen requirements on moving to more generous plans. One of the problems in Municipal Fire Plan 5, where most firefighters are, is that people can traipse in from a different plan, log in 3 years, and suddenly take advantage of the most generous of all the PERA plans (it pays 3.5% of FAS for each year; most major PERA plans pay 3%). Similar to the more common definition of spiking, this type of plan-climbing results in greater benefits than were paid for by the employee and employer over the years.

Particularly since any pension changes will likely widen the gap between public safety and non-public safety plans going forward, at a minimum the legislature and PERA should make it much tougher to adopt the more generous plan if there isn't a far longer participation than 3 years. All of the PERA plans are pretty good, so asking people to pay in for a longer period for more generous plans isn't really hurting anyone--it's just protecting the fund.

If the reform legislation were to include a Rule of 85 with a public safety enhancement ONLY for those years when the employee worked a public safety job, that would effectively solve this problem.

D. Increase contribution rates for the funds that are in the most trouble. Firefighters in particular have been willing to fork over more money out of their own pockets to ensure that future firefighters are able to have a 20 year retirement. (Again, AFSCME does not speak for the firefighters, but they had a bill to do just this in the 2011 session). If members are willing to do that, PERA and the employers shouldn't turn down that offer to improve solvency, particularly in the plans (fire, judicial) that aren't doing as well as some of the others.

E. Don't give full time credit to part time workers. Right now, someone can work 22 years doing part time work, work 3 years at full time work, and end up with a full-time pension. Part-time work needs to be valued and respected, but we shouldn't be doubling its value by giving full-time service credit. Not only does this make no policy sense, but if widely used, is terrible for the fund. Even if someone is working at the exact same job with the exact same pay when they're full and part time, during the part time years they and their employer are putting less money into the fund—up to 50% less. If we want pensions to more accurately reflect what a person and their employer(s) have put in over the years, we must give part time service credit for part time work.

F. Establish a consistent "public safety" definition for once and for all. I'm not sure all jobs currently covered by "public safety" are truly the types of jobs that should have a 20 year retirement. There seem to be a fair amount of desk jobs that somehow get swept up in the 20 year retirement, and there's simply no policy reason for that. In fact, if you want to have a well-run corrections, fire, police, and juvenile corrections department, you should avoid 20 year retirement for management who aren't on the front lines fighting criminals or fires most days. There are other inconsistencies, like the fact that all correctional facility employees, including state adult correctional, local adult correctional, and local juvenile correctional workers have a 20 year retirement, but not state juvenile corrections officers. Actuaries would have to run the numbers to retroactively include state juvenile corrections officers in public safety, but at the very least going forward they should be in that same category.

The legislature may have many other requests, like for Probation and Parole, 911 operators, Game and Fish personnel, and Motor Transport Division, and I'd recommend adding any of them in in the order presented here, but at the very least, adult corrections, juvenile corrections, police, and fire should all be considered public safety.

Section 3: Preservation of some current policies

A. Keep the policy banning double dipping. Double dipping is a problem, first and foremost, because the fund takes a big hit when people "retire" earlier than they otherwise would have. A nearly unanimous bipartisan coalition resisted the temptation to carve out a number of exceptions last year, but that coalition is being tested by claims that cities, counties, courts, and some state agencies can only recruit and retain qualified workers if they allow double dipping.

If we need to improve recruiting and retention, let's do it the old fashioned way: by making the jobs more attractive rather than simply relying on PERA to subsidize jobs. PERA is not a piggy bank, and no matter how important the job being discussed or how good the intentions of legislators, hurting the PERA fund to help government make payroll is a bad idea.

What about low-paying part time jobs, like elections workers, crossing guards, or legislative staff? Those are different from allowing double dipping at full time, better-paying jobs, because no one is going to change their behavior and start drawing their retirement at the first available date to become a crossing guard. A police officer will gladly retire the very day he or she is eligible if they can get an equally good or better paying job as, say, an undersheriff, but no cop is going to quit for the glamorous $8,000 a year gig as a crossing guard. That means that the part-time, low-cost jobs aren't hurting the fund, because they don't change behavior.

But full-time, higher-paying jobs that allow double dipping completely alter behavior and result in PERA paying out benefits for more years than they otherwise would have. Maybe a handful of people double dipping won't hurt the fund, but 20, or 50, or 100 a year? Those extra payments start to get into the millions, not to mention opening the door for revisiting double dipping for all law enforcement. Or all small towns. Or all judicial branch workers. Or any position where the boss couldn't find someone "as qualified". Then you're well into the tens or hundreds of millions of dollars lost to double dipping, and no fund, not even a relatively sound one like PERA, can withstand that type of drubbing for long.

B. Don't lower contribution rates. If the first priority of pension reform is to ensure long-term solvency, and we're lowering future employees' benefits to do so, why on earth would we also lower contributions? Let's wait until the plans get well over 100% solvency, using conservative assumptions, before considering lowering rates. Yes, that means future employees are going to be paying the same amount for a lower benefit, and that seems unfair. But it's not, for several reasons. The main reason it's not unfair is that future employees will be applying to the state knowing darn well what the deal is. Slightly reduced (but still very good) pension at the same cost. Don't like it? There's nothing stopping you from finding a private employer or public employer in another state.

Second, it's not like having overall lower contributions is suddenly going to result in a lot of raises for the new workers. For example, the Ideal Plan calls for employees in State General Plan to pay 7%, and the state to pay 14%. The current members are paying 7.42% and the state 16.59% (once the temporary pension swap goes away). Are new employees really going to feel better about a lower-benefit plan because they pay 0.42% less? And is there any chance that the state is going to turn around and give the new workers a 2.59% raise above the older workers? Don't count on it.

It's far easier to maintain the current status quo on contribution levels and then lower them if we ever become super-solvent than it is to find out that a few assumptions were wrong and trying to raise contribution levels back up again. Plus, we'll be building a cushion in the event that we have another downturn like 2008-2009 or in the event that we don't meet our 8% assumed rate of return, or in the event that the actuaries were off on any other number of assumptions (longer life spans, anyone?).

If the plans end up being well-overfunded, which they may with these changes, then we can and should consider both employer and employee contribution reductions, but until then, ensuring long-term solvency should be the primary focus of any reform plans, and at a minimum that means preserving current contribution levels.

C. Preserve employer/employee splits where employers have agreed to pick up a portion of the employees' contributions. Under current law, local employers are allowed to make an irrevocable decision to pick up part of the employees' contribution. There are questions as to whether these irrevocable decisions would still apply if we create a new tier of benefits. This issue does not, in any way, impact PERA solvency, but it could result in about a 10% pay cut for tens of thousands of employees around the state.

Pension reform is not meant to be either a windfall to local government nor a huge pay cut for workers, so we would respectfully ask that you take whatever measures are necessary to ensure that current splits stay in place when pensions are reformed. LCS drafters can undoubtedly come up with better language, but something like "nothing in this legislation shall change any employer pick up of employee contributions for current or future employees".

D. Do not expand air time provisions. PERA allows people to "purchase" years of service. I'm sure the actuaries have their numbers right, but first, as noted in some of the above ideas, it's simply bad policy to shorten service when people are in the primes of their careers. Second, while the actuaries' numbers are undoubtedly right given their assumptions, it seems likely that people would only do it when the numbers are in their favor. That may mean that the actuaries are right theoretically, but that the math doesn't work in the real world. Not only should airtime not be expanded, but we believe that it's bad policy, bad politics, and possibly bad for the fund and should be eliminated.

E. Uphold promises to current employees. It's nothing less than a bait-and-switch, or broken promise, to change the plans of current retirees and members. People have taken jobs in the public sector in New Mexico and kept them even when they've had opportunities to go to the private sector, federal government, or other states, often relying on the promise of the existing retirement plans. That's to say nothing of the strong constitutional and contract claims that will be made by, at the very least, every current retiree and previously-vested member.

The recent Colorado and Minnesota decisions do not directly affect New Mexico law, and some parts of those decisions indicate that where the employer has consistently made a promise, courts will be less likely to uphold a breach of that promise (for example, in Colorado, the lower court ruled that one reason it was legal to change the COLA was because it had changed so many times in the past). Regardless of the legality, however, it is fundamentally unfair to change the rules mid-stream on people who guard our jails, nurse our sick, and teach our kids.

Summary

We believe this memo represents a strong array of significant, permanent reforms here, and believe that this is an opportunity to simultaneously address solvency, perception, and policy issues in one fell swoop. Starting the very first year people are hired under these new proposals, solvency numbers will improve, because the solvency number is simply assets divided by current and future liabilities. Liabilities will start going down with the very first set of new employees under these plans, even in the public safety plans, and we believe these ideas provide not only enough to attain long-term solvency, but to get us there quickly, and with a great cushion to absorb the next downturn in stride.

If it seems like the cumulative effect of these ideas is to take the pension plans well beyond GASB-endorsed solvency levels, it's because they should, and we want them to. GASB recommends 80% solvency. Last year's Ideal Plan does that (without affecting current retirees or members, by the way, and without higher contribution rates--in fact, the Ideal Plan lowers future contribution rates). However, there are all kinds of assumptions that could go wrong.

No one can say for certain that PERA will be able to attain an 8% rate of return over the next decade or even 30 years. We'd rather strengthen the solvency of the plans to 100% or higher, giving us a cushion for unexpected events or simply incorrect assumptions. The Ideal Plan also required higher contributions from employers and employees, which in the current fiscal crisis may not be welcome (and may not be welcome in any fiscal atmosphere given that our current total contribution levels are relatively high).

As always, please call Carter Bundy (505-463-8499) or Josh Anderson (505-350-2200) if you have any questions or want to discuss pension reform. Together, we have the opportunity to make these plans the best-funded, most stable in the country, for decades to come, while still providing employers with a powerful recruiting and retention tool and employees with good retirement security. Thank you!